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Research paper

What characteristics of board of directors affect Indonesian bank performance?

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Abstract

The sustainability of a firm is determined by the effectiveness of its board of directors. Hambrick and Mason's Upper Echelon theory states that management characteristics could predict organizational outcomes. This study examines the effects of the characteristics of board of directors on the performance of publicly-traded banks in Indonesia. The measures of board characteristics are educational attainment, presence of independent directors, employment of foreign directors, compensation of directors, and age of directors. Our 58 firm-year observations from 2014-2015 were analyzed using fixed effects model. We find evidence that bank profitability is (i) positively affected by doctorate education of board members and (ii) negatively affected by remuneration of top executives. Based on our findings, we would suggest corporations to: comply with governmental regulations regarding the employment of independent directors, align the interest between principals and agents to eliminate agency problem, and accommodate board members with scholarships designated for academic development.

Keywords: *Corporate Governance; Bank Performance; Board Characteristic; Agency Problem; Upper Echelon.*

1. Introduction

The management is responsible for value enhancement and performance improvement in corporations. A good corporate governance system assures efficient and effective corporate practices conducted by the board of directors (BOD). Indonesian corporations follow a two-tier board structure, i.e. a definitive separation of board of commissioners (BOC) as overseer and BOD as top executives. Established in the corporate structure, general meeting of shareholders holds highest authority; they select and dismiss BOC. The BOC, which represent shareholders' interests, directly supervise BOD to ensure the effectiveness of management activities (Arifin, 2005).

Jensen (2002) states that the main objective of a firm is to maximize its value. However, achieving such objective has to be done ethically. This is where corporate governance plays it role. Rezaee (2007) argues that the role of corporate governance is to minimize agency costs and to create long-term shareholder value; focusing on responsibilities of BOD in monitoring the functions of senior executives. Kowalewski (2016) also argues that corporate governance would increase dividends. He furthermore states that during times of financial crisis, corporate governance would generate higher ROA. However, Essen, Enggelen, and Carney (2013), in their study of 1,197 firms in 26 European countries, give evidence that corporate governance practices may harm firms in certain situations. These findings lead to the question whether the benefits of good corporate governance are wide-ranging or merely fractional.

Alwi (2009) generally defines corporate governance as a system, structure, mechanism, process, or a set of rules outlining the relationship between parties in a corporation, which establishes clear entitlements and responsibilities. Whereas Shleifer & Vishny (1997) define corporate governance as a mechanism in which owners of companies receive their return on investments. It is the duty of BOD to make sure that corporate governance is implemented properly for the sustainability of the organization. The human resource element is crucial for fulfilling the duty of the board.

Hambrick and Mason (1984) theorized that organizational outcomes could be partially predicted by managerial background characteristics. This is called the Upper Echelon theory. For the sake of maintaining sustainable competitive advantage, certain characteristics would be required from the members of the BOD. This has been proven by Mohamed, Jarboui, Baccar, and Bouri (2015), who found that these characteristics could largely affect firm values.

One of the characteristics is intelligence. Caplan and Miller (2010) drew conclusion that education is proxy for intelligence. There have been previous studies showing positive relationship between educational attainment and firm performance such as King, Srivastav, and Williams (2016). However, Darmadi (2013) stated that in Indonesia, high-performing firms were founded and managed by people who were not highly-educated. Lindorff & Jonson (2013) also found that there were no relationship between business educations of Australia's top 200 CEOs and firm financial performance.

Another demographic factor that could influence the firm performance is the director's age, as discovered by Amran, Yusof, Ishak, and Aripin (2014). Ting, Azizan, and Kweh (2015) found that younger CEOs are more likely to be aggressive and risk-taking. While Cline & Yore (2016) found that the age of S&P firm CEOs were negatively related to firm value and performance.

The financial industry is one of the most exposed industries due to the occurences of global financial crisis. According to the Financial Services Authority of Indonesia (2015), the Finance industry deeply affects the dynamic of the country's economy not only as financier for producers and consumers, but also as an institution of wealth storage. The prioritized economic agenda of Indonesia is the optimization of SME, with banks front-lining this effort because they are still by far the most utilized and trusted financial institution in Indonesia at 74%. The good implementation of corporate governance becomes particularly important in the banking sector.

Based on the importance of BOD in implementing good corporate governance and increasing firm value, supplemented by previous empirical result inconsistencies, we would like to reassess the effects of educational attainment, age of top executives, and other board characteristics on bank performance. To our knowledge, this study would be among the first to focus specifically on bank performances. It has been rare in nature due to the difference of regulations compared to the other non-financial counterparts.

2. Literature review

According to the Modern Corporation and Private Property (1932), as written by Berle and Means (as referenced in Kang & Sorensen, 1999), it is pronounced that there should be a separation of owners and managers within corporations. The division of control and ownership would institute firms as autonomous entities. Managers operate the firm and maintain its going-concern, while owners perform control functions and invest in capital.

The division of ownership and control results in an agency relationship. This relationship occurs when principals (owners) entrust their power and authority to the employed agents (management). This arrangement between different parties in corporations is referred by Jensen and Meckling (1976) as nexus of contracts.

Corporate governance is required for designing management strategies, creating firm value, and resolving agency conflicts. According to Hart (1995), the surge of corporate governance issues has been caused by the conflict of interests within the organization and the costs of transacation arising from unresolved agency problem (unsolvable through contracts). He states furthermore that through efficient corporate governance, the market economy can be achieved.

Rezaee (2007) expresses that corporate governance structure consists of seven functions: oversight, managerial, compliance, internal audit, advisory, external audit dan monitoring. Firm performance is heavily affected by three out of the seven corporate governance functions:

i) Oversight, conducted by the board of commissioners.
ii) Managerial, executed by the management or top executives, and.
iii) Monitoring, performed by the shareholders.

Therefore, an effective corporate governance depends on the division of power between the aforementioned three parties. Additionally, internal and external mechanisms of corporate governance have to be installed not only to organize and control the relationship between all parties in corporate governance, but also to design remuneration policies for the management. Only then, values can be created for shareholders, and the interests of other stakeholders can be secured.

One approach of internal mechanism that can address conflict of interests is applying contracting theory. Jensen (2002) indicates that agency theory is a useful tool for analyzing determinants in constructing complex contractual arrangements. These contracts comprise compensation and reward plans for agents, which could be based on certain performance measures. Such legal agreements reflect the division of management decisions and control decisions.

Our study focuses on the management function in corporate governance that has been delegated from the shareholders to the care of the agents: the resources that operate the organization.

2.1. Education and bank performance

Jarboui, Baccar, and Bouri (2015) found that CEO's technical education could increase firm value. By implication, the education of all BOD members could also affect firm values. Mohamed, Darmadi (2013), in his study of listed Indonesian companies, found that CEOs holding degrees from prestigious domestic universities performed significantly better than those without such qualifications. Whilst in the United Kingdom, King, Srivastav, and Williams (2016) found that educational attainment influenced performances of banks; those that were led by CEOs with MBAs outperform their peers.

Furthermore, according to the Upper Echelon theory by Hambrick and Mason (1984), intellectual competence and high knowledge could be indicated by a higher education level. Therefore, we formulate that educational attainment could affect firm performance:

H_1: Education of BOD members positively influence bank performance

2.2. Age and bank performance

Shen (2014) showed that adversity quotient increases with age, enhanced through learning. The older senior executives are, the more experience they possess. These experiences are not only industrial and professional in nature, but also personal.

Ben Mohamed, Baccar, Fairchald, and Bouri (2012) showed that older CEOs were more rational. Ben Mohamed, Jarboui, Baccar, and Bouri (2015) also found that CEO's age had positive effect on firm value. We formulate the second hypothesis as follows:

H_2: Age of BOD members positively influence bank performance

2.3. Independent directors and bank performance

Indonesian Stock Exchange Regulation Number I.A and Circular Letter No. SE-00001/BEI/02-2014 dictate that listed companies should have at least one independent director. Independent director is an executive, who is not affiliated with controlling shareholders, directors, commissioners, and not employed by other corporations as director. He or she has to be a professional from outside the company and is chosen to represent and protect the interests of the minority shareholders

Liu, Miletkov, Wei, and Yang (2015) found that in China, independent directors had positive effect on firm operating performance. Cavaco, Crifo, Reberioux, and Roudaut (2017) also supported a similar finding that independent directors have even higher abilities than affiliated ones. Zhu, Ye, Tucker, and Zhan (2016) suggested empowering independent directors that could lead to more effective monitoring and higher firm value. Based on previous studies and the possibility that board independence could also reduce agency cost, we formulate:

H_3: Independent directors positively influence bank performance

2.4. Existence of expatriates and bank performance

The recruitment of expatriates is expected to bring foreign and more developed knowledge and skills to the corporate asset. Muravyev (2017) found that proportion of foreign directors were positively related to company performance. Tee, Aik, and Lim (2016) also found that increase in percentage of foreign directors on the BOD significantly improved profitability.

The employment of expatriates would also directly enhance the board's diversity, therefore we hypothesize:

H_4: The existence of foreign directors positively influences bank performance

2.5. Compensation and bank performance

One of the sources of agency costs is the divergence of interests between the firm owners and the employed top executives. According to agency theory, this issue could be reduced by paying the management executives with compensation, as a reward for good financial performance.

Gao & Li (2015) found that CEO pays were positively related to firm accounting performance. Subekti (2015) also gave evidence to positive effect of executive compensation on ROA. Shim & Kim (2015) showed that American CEOs' total compensation is significantly and positively related to ROA. These findings show that compensation could stimulate high firm performance, as well as align the agent's interests with the principal's.

H_5: Executive compensation positively influences bank performance

3. Methodology

Our research sample consists of publicly-traded banks in the Indonesian Stock Exchange. After a series of eliminations, 29 banks were observed for a period of 2 years, resulting in 58 firm-year observations. The inclusion criteria for our sample were as follows:

i) Banks listed in the Indonesian Stock Exchange, and.
ii) Banks with comprehensive data, specifically the profile information of BOD, for the financial years 2014 and 2015. Data were extracted from annual reports and company websites.

The response variable of this research is bank performance. The measure is bank profitability adjusted for industry trends: the bank's Return on Assets minus the mean Return on Assets of all the other banks on an annual basis. This is done in order to eliminate industry-wide component that is uncontrollable to the directors and unrelated to their talents (King, Srivastav, & Williams, 2016). Our data were then analyzed using descriptive and panel data regression models on EViews software.

Table 1: Variable Definitions

Variable	Definition	Formula
Education (EDU)	Education of board members. Proportion of those with postgraduate (doctorate) degrees	Number of directors with doctorate degree/Total number of directors
Age of directors (AGE)	Average age of board members	Total age of all directors/ Total number of directors
Independent directors (INDIE)	Proportion of board members who are unaffiliated	Number of independent directors/ Total number of directors
Foreign directors (EXPAT)	Proportion of board members whose nationality is not Indonesian	Number of foreign directors/ Total number of directors
Directors' compensation (PAY)	Proportion of top executive's compensation relative to the firm's total employee expenses	Total management compensation/Total employee expenses
Firm performance (PERF)	Return on asset; the profit achieved from the firm's resources	Return on assets – Average ROA for banking sector

4. Findings & discussion

Table 2: Descriptive Statistics

	EDU (%)	*INDIE* (%)	*EXPAT* (%)	*PAY* (%)	*AGE* (year)	*PERF* (%)
Mean	1.949	9.223	9.561	6.5355	52.37	0.3006
Maximum	40.0	100.0	50.00	19.225	58.00	3.654
Minimum	0.00	0.00	0.00	0.524	47.00	-1.474
Std. Dev.	6.862	20.644	14.399	4.546	3.067	1.2504
Observations	58	58	58	58	58	58

Our descriptive statistics (refer to Table 2) result shows that only 6 banks employed board members holding doctorate degrees, with the BOD of PT. Bank Yudha Bhakti Tbk. being the most-educated at 40%.

Despite the compulsory nature of independent directors in Indonesia, its implementation is still subpar: *INDIE* shows an average of 9.2%. PT. Bank Agris Tbk. led the banking sector with 100% independent BOD. As for foreign directors, *EXPAT* averaged 9.56%. Board members of PT. Bank QNB Kesawan were 50% expatriates. There were also 19 corporations that did not employ foreigners as their directors.

When it comes to compensation of directors, BOD of PT. Bank Dinar Indonesia Tbk. took the largest chunk of the bank's employee expenses at 19.22%, while PT. Bank Rakyat Indonesia Tbk. took the lowest at 0.52%. While the sector averaged in 6.54%.

The average age of Indonesian bank directors was 52.37. PT. Bank Pan Indonesia Tbk. had the oldest board members; averaging in 57 years old, while PT. Bank Pembangunan Daerah Jawa Barat Tbk. had the youngest members at an average of 47 years of age. Our data shows that Indonesian board members were middle-aged or older.

Lastly, PT. Bank Rakyat Indonesia Tbk. generated the highest *PERF* at 3.65%, while the bank with the lowest *PERF* was PT. Bank Agris Tbk.

Table 3: Redundant Fixed Effects – Likelihood Ratio Testing

Redundant Fixed Effects Tests			
Test cross-section fixed effects			
Effects Test	Statistic	d.f.	Prob.
Cross-section F	5.954673	(28,24)	0.0000
Cross-section Chi-square	120.222948	28	0.0000

Prior to running the regression to test our hypothesis, we had to determine which panel data estimator would be best for our model by conducting Redundant Fixed Effects test and Hausman test.

The redundant fixed effects-likelihood ratio testing shows a p-value lower than 0.05 level of significance. It can be concluded that fixed effects estimator would be better than ordinary, pooled OLS and that it can be utilized in our data analysis. However, Hausman test was also performed to determine whether random effects estimator would be better than fixed estimator.

Table 4: Hausman Test

Correlated Random Effects - Hausman Test			
Test cross-section random effects			
Test Summary	Chi-Sq. Statistic	Chi-Sq. d.f.	Prob.
Cross-section random	2.591739	5	0.7626

Table 4 shows a p-value of 0.7626, greater than 5% level of significance. We can conclude that random effects estimator would be better and more efficient than fixed estimator for our model. Table 5 summarizes the results of panel data regression using random effects estimator:

Table 5: Panel Data Regression Results

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.841873	2.775097	0.303367	0.7628
EDU	0.032237	0.016942	1.902765	0.0626**
INDIE	-0.009913	0.008744	-1.133765	0.2621
EXPAT	-0.011382	0.013126	-0.867120	0.3899
PAY	-0.096628	0.043051	-2.244498	0.0291*
AGE	0.004164	0.053514	0.077804	0.9383
Effects Specification				
			S.D.	Rho
Cross-section random			1.033217	0.7512
Idiosyncratic random			0.594600	0.2488
Weighted Statistics				
R-squared	0.164723	Mean dependent var		0.113296
Adjusted R-squared	0.084408	S.D. dependent var		0.606844
S.E. of regression	0.580668	Sum squared resid		17.53315
F-statistic	2.050967	Durbin-Watson stat		1.969176
Prob(F-statistic)	0.086663			
* corresponds to 5% level of significance				
** corresponds to 10% level of significance				

a) Education & Bank Performance

EDU shows a p-value of .0626, therefore accepting H_1 at .1 level of significance. Educational attainment of BOD, which was measured with doctorate degrees, positively affects bank performance.

Board members with higher educational qualifications are considered to possess higher intelligence and management capabilities. Gottesman and Morey (2006a) argued that managers with higher education would be more innovative and adaptive, they also possess other characteristics that positively influence bank performance. Moreover, the higher the education, the more problem-solving methods that can be applied. Our finding supports the Upper Echelon theory and is consistent with King, Srivastav, and Williams (2016) and Akpan and Amran (2014), who found that educational attainment affects firm performance; those who have received higher education would possess knowledge, experience, and the skills to manage performance and organizational affairs.

b) Independent directors and bank performance

The p-value for *INDIE* is .2621 and consequently, H_2 was rejected. Our finding is in line with Adams (2016). The insignificant result may arise from the fact that many banks still have not installed independent, unaffiliated board members. It should also be noted that the Indonesian Financial Services Authority had only introduced this regulation in September of 2014.

c) Foreign directors and bank performance

EXPAT shows a p-value of .3899, therefore rejecting H_3. The negative and insignificant effect of this variable could arise from the assumption that expatriate existence would contribute international experience and perspective to the company, and yet it achieved the contrary. This finding is line with Masulis (2012), who gave evidence that while foreign BOD members bring in diversity, expertise, and additional perspective, they bring down profitability. Decrease in ROA can be caused by (i) increase in expenses or decrease in revenues, or (ii) the acquisition of assets that do not generate yield. This may be triggered by the shareholders or commissioners overestimating the capabilities of the expatriates, causing increase in remuneration expenses. Moreover, expatriates are compensated more than local human resources.

d) Directors' compensation and bank performance

PAY has a p-value of .029. However, even though the p-value is lower than the .05 significance level, the effect of directors' compensation on bank performance was found to be negative. Thus, H_4 was rejected. This is in line with Matousek (2015), who found that executive compensation negatively influences banks' operating efficiency.

Remuneration of BOD is accounted for in expenses, which would hinder firm performance. Costs of remuneration are also a function of agency conflict: directors are so focused on their own interests in pursuing incentives that management decisions negatively affect the company as a whole.

e) Age of directors and bank performance

AGE shows a p-value of .9383, which rejected our last alternative hypothesis. The absence of this explanatory variable's effect may arise from the relatively old age of the directors. The majority of Indonesian bank board members can be categorized as seniors. Older ages are often considered to be synonymous with work and life experience, wider network, and independence, but our finding shows that it does not significantly influence firm performance. However, if BOD had younger members, they would tend to be more innovative, efficient, and responsive toward risks (Ness, Miesing, & Kang, 2010).

5. Conclusion

Our findings show that there are characteristics of board of directors that influence firm performance in the Indonesian banking sector:

1) Education positively affects bank performance.
2) Remuneration of top executives negatively affects bank performance.
3) Age of directors and the existence of independent directors and foreign directors do not significantly influence bank performance.

Implications

- Corporations should consider accommodating their top executives to enrol in higher education institutions. In doing so, they could stimulate organizational improvement. Other than recruiting directors that possess expertise in their fields and high educational attainment, shareholders would still need to provide management with trainings and scholarships designated for academic development.
- *A priori*, independent directors are favorable for corporations. However, our findings show that there are only the least amount of firms with independent directors. We would suggest organizations across the nation to conform to government regulation and employ independent directors.
- When it comes to remuneration or compensation, there needs to be an alignment of interests between principals and agents. Contracts should be constructed by putting emphasis on objectives, so that the remuneration that would be rewarded accordingly. As a result, the costs of remuneration would correspond with the realized organizational performance.

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